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TAGS: ECON EFIN EINV RS
SUBJECT: HAS THE RUSSIAN ECONOMY BOTTOMED OUT?

REF: A. MOSCOW 2528
¶B. MOSCOW 2541

Classified By: Economic Minister Counselor Matthias Mitman for Reasons 1.4 (b/d)

SUMMARY

¶1. (SBU) President Medvedev recently announced that the worst of the recession was over, but real losses suffered by the economy were more severe than anticipated. The industrial sector, particularly the single-company towns, was hard hit, with unemployment remaining at an unprecedented high. Medvedev declared that GOR policies to support the banking system and last fall's gradual devaluation of the ruble were successful. Controlling inflation together with continued GOR social spending would help stimulate domestic demand. He concluded by stressing the need to diversify and modernize the economy, but predicted Russia would take 10-15 years for the transformation to be complete.

¶2. (C) Leading economic analysts anticipated a gradual upturn in GDP growth of one to two percent over the next year. That said, economic growth will be constrained by continued unemployment and lower incomes, as well as the difficulty of state and private banks to find sound borrowers in Russia's corporate sector. Several analysts believe Russia's growth will continue to remain dependent on commodity exports and increased budgetary outlays in the near term. Medvedev's chief economic advisor Arkady Dvorkovich told us that while the economic slide has stopped, seasonal factors will result in increased unemployment in the next several months. Dvorkovich agreed the economy will rebound slowly but that Medvedev's proposed privatization of state assets represented a strategic approach to restructure key sectors and would lay the foundation for higher long-term growth. Some analysts remain skeptical, believing privatization plans are merely a mechanism to raise additional revenue to plug the GOR's growing fiscal deficit. End Summary.

The Worst My Be Over....

¶3. (SBU) In a televised interview on October 11, President Medvedev summarized the state of the Russian economy. While the worst of the recession was over, he stated, the real losses suffered by the Russian economy were more severe than expected by Russian authorities. Initially, the economy was expected to decline by 3 to 3.5% this year. In reality,

Medvedev predicted GDP likely will fall by 7.5%. He claimed the authorities had acted skillfully in dealing with the consequences of the crisis, avoiding the worst in unemployment (although the real figures had reached an unprecedented 7.5 million) and saving the banking system - thereby avoiding "negative social consequences". Medvedev pointed out that the "mono-cities" (single company towns) remained a big problem and that the authorities were forced to use "manual control" to deal with them. The agricultural sector had fared better than the industrial sector, partly because imports were replaced by domestically produced agricultural items. Medvedev noted that the gradual devaluation of the ruble was a necessary measure in the early months of the crisis (given the fall in commodity prices), even though it had some negative consequences on incomes.

¶4. (SBU) Medvedev stated that the situation with the national currency was "calm and stable". He cited the success of the anti-crisis measures, combined with higher oil prices, as justifications for cautious optimism. Controlling inflation together with social spending would increase Russians' purchasing power and stimulate domestic demand. Medvedev indicated that the GOR planned to have a deficit-free budget or a "minimal" deficit in one year. When asked about his upcoming Federal Assembly address and modernization, Medvedev repeated much of his "Russia Forward" agenda, stressing the need for economic diversification, modernization, innovation and political reform, as well as energy efficiency and pension reform. He anticipated that the transformation of Russia's economy may take 10-15 years to complete.

...but Anti-crisis Measures Will Go On

¶5. (C) In a meeting with Econmincouns after the broadcast of Medvedev's interview, Medvedev's Economic Advisor Arkady Dvorkovich explained that most economic indicators, including industrial output, appear to show that the Russian economy has bottomed out. Dvorkovich noted, however, that unemployment figures are likely to worsen over the next several months as seasonal factors cause increased unemployment in Russia's construction and agricultural sectors. He stated that the GOR would continue its anti-crisis measures, as needed, to provide social spending for unemployment as well as budgetary support to sectors most affected by the financial crisis. Dvorkovich acknowledged that resumption of Russia's economic growth will be gradual and dependent on global economic conditions. While noting the importance of higher commodity prices on world markets, he stated that a stronger global recovery would be equally important (especially to the GOR budget) in increasing the quantity of Russia's commodity exports.

The View of the Analysts

¶6. (C) We also solicited the views of several leading Moscow-based economists on Medvedev's assessment of the Russian economy. Yaroslav Lissovolik, Chief Economist with Deutsche Bank, agreed that the Russian economy was beginning to rebound. He believed that household consumption was the key to economic recovery. Positive drivers for household income were the relatively stable ruble and higher budget outlays in the fourth quarter. He noted that, traditionally, almost 50 percent of public spending comes in the final four months of the year. Many budget outlays, particularly in the social sphere, would benefit the consumer and spur domestic demand. Lissovolik, however, cited several significant obstacles that could constrain the upswing in domestic demand: the decline in wages in many sectors, relatively high unemployment, and the unavailability of consumer credit.

¶7. (C) Vladimir Osakovsky, Head of Strategy and Research at

Unicredit Bank, predicted that the Russian economy would begin showing considerable growth owing to the effects of a massive fiscal stimulus at the end of the year; falling interest rates (linked to a nearly two month zero inflation streak); and a rebounding of certain export markets. In particular, Osakovsky forecast an acceleration of Russian gas supplies to Europe, a view not universally shared (see reftels). Russian industrial output (which recovered from a 17% y-o-y decline in April-May to a better than expected 10.8% y-o-y decline in July) benefited from a growth in demand in major export markets (particularly China) and an increase in investment demand, owing in part to falling interest rates and thawing capital markets. That said, Osakovsky, like Lissolvolik, was pessimistic about a quick turn-around in domestic consumer demand. According to his data, unemployment remained at an eight-year high as companies continued to downsize. Real wage contraction had intensified since the beginning of the year, driving down disposable income growth. Retail sales, which had plummeted to the lowest levels since 1999, remained in a deep downward spiral.

¶8. (C) Natalia Orlova, Chief Economist at Alfa Bank, told us the Russian economy reached bottom in May-June and was beginning to stabilize. She predicted, however, Russia would achieve at best a one-to-two percent growth rate over the next two years. Domestic drivers of growth, in her view, remained weak: household consumption was constrained by the decline in disposable income and, contrary to what Osakovsky argued, investments were not picking up. In her view, in spite of falling domestic interest rates, state and private banks were hard put to find sound - or even solvent - borrowers. Banks were hedging against default by their major clients (usually large corporations) through "creative" refinancing: rolling over debt, or creating new loans to cover old loans. Moreover, she explained, by borrowing internationally to help finance the budget deficit, the GOR was effectively competing with private sector borrowers and squeezing them out of the market by raising the costs and

risk premium for private borrowing.

¶9. (C) Ruben Aganbegyan, President of Renaissance Capital, told us that Russia's economic recovery depended largely on the global economic upturn. The recent recovery in Russia's economy has resulted, in part, because of growth in the demand for Russia's traditional export items, i.e., oil, gas, steel, and other natural resources. However, the upward curve in Russia's equity markets was contrasted by a downward curve in the growth of Russia's "real economy" - i.e., domestic demand and household consumption. Russia's equity markets, in turn, were a close proxy to oil prices, and falling prices could take down those markets as well. While the current strengthening of Russia's equity markets had increased demand for the ruble, continued appreciation of the ruble, in his view, could threaten prospects for economic recovery by undermining the earnings of Russia's exporters.

¶10. (C) Regarding the appreciation of the ruble, Dvorkovich explained that the Russian Central Bank's recent intervention (by adding international reserves through purchases of several billion USD) reflected a desire to manage market volatility and mitigate the negative impact on Russian exports. Dvorkovich noted that recent Russian money supply growth has been flat and the Central Bank could sterilize, as appropriate, additional accumulation of reserves. He predicted that inflation in Russia relative to other industrial and emerging economies would remain high. That said, Dvorkovich expected the gradual rebound in Russia's economy would facilitate a disinflation policy that would lead to gradually declining inflation over the next several years.

Looking Ahead: Privatization and Other Reforms
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¶11. (C) Analysts generally welcomed recent statements by Medvedev and Putin about the necessity for wholesale systemic reform, a decrease of state interference in the economy, and increased privatization. Regarding privatization, Natalia Orlova believed that the GOR's primary motivation was to raise money (up to 100 billion rubles) to help close the budget deficit. She doubted the government would ever forfeit its controlling share of Rosneft, adding that it would be difficult to find buyers for other state assets subject to privatization (ports, infrastructure) owing to the shortage of cash. Thus, much of the state property would have to be sold at a discount. Ruben Aganbegyan, on the other hand, argued that the architect of the privatization plan, First Deputy PM Shuvalov, was intent on using privatization as a prelude to thorough structural reform of strategic sectors. Aganbegyan, who said he was in frequent contact with Shuvalov, claimed the latter was serious about privatization of Rosneft, albeit with the government perhaps retaining a simple majority of the shares.

¶12. (C) Dvorkovich stressed to us that Medvedev's privatization proposals reflected a strategic approach to restructuring certain sectors in the Russian economy. The resulting proceeds would provide some budgetary support but Dvorkovich noted this would be a secondary effect. He stated that the government is still developing detailed proposals on privatization and expected to announce them over the "next several weeks." Dvorkovich commented that the GOR would seek to include additional private ownership in state-owned enterprises involved in economic infrastructure. He agreed that it was unlikely, however, that the GOR would relinquish majority ownership in the privatized enterprises. Dvorkovich hedged on timing for implementing the privatization proposals, noting the GOR had a responsibility to protect Russian taxpayers' equities in any sales of state-owned enterprises.

Comment

¶13. (C) Despite normal caveats about Russian economic data, the most recent indicators appear to confirm that the worst of the recession is over here, and a slight recovery has taken place. This improvement reflects primarily more robust end-of-year public spending and growth in export demand and prices (primarily commodities). Still, the situation for

most Russians has not noticeably improved. Domestic consumer demand remains depressed due to falling incomes, and the continued deceleration of consumer demand likely will continue into next year. Russia's economic growth will remain dependent on the global recovery to stimulate Russia's resource exports and revenues. Global market conditions will also be an important determinant of the prices Russia receives for oil, gas, and natural resource exports.

¶14. (C) The GOR has yet to match its considerable recent rhetoric on modernizing the economy with significant action to increase privatization and investment in economic infrastructure. The jury remains out on the efficacy of GOR anti-corruption measures, improved governance policies and efforts to better target public spending. The economic crisis over the past year appears to have reinforced to the GOR leadership the need to obtain positive results on economic reform proposals, especially to enable Russia to attract the foreign investment necessary to accelerate public investment in both infrastructure and investment projects in key industrial sectors. End Comment.
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